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SUBJECT: AMBASSADOR'S CALL ON MINISTER OF FINANCE PAPAKONSTANTINO

REF: A. 09 ATHENS 1621; B. 09 ATHENS 371

SUMMARY

1. (SBU) Ambassador Speckhard's November 16 courtesy call on newly-appointed Minister of Finance George Papakonstantinou underscored the challenges confronting the new Greek government as it seeks to shore up deteriorating Greek public finances, bridge a credibility gap created by the misreporting of economic statistics by previous governments, and maintain popular support by balancing politically-difficult reforms with delivering on campaign promises. The Minister admitted Greece's economic and fiscal situation is dire and will require politically difficult decisions and reforms in the coming months. Chief among his immediate priorities for the Ministry will be to address the two key structural impediments to improving public finances: an ineffective tax administration system and an inadequate budget process. The Minister asked for technical assistance from U.S. tax and budget experts, namely the IRS and OMB.

2. (SBU) SUMMARY CONTINUED. Papakonstantinou told the Ambassador that his goal is to shrink the deficit from 12.7 percent in 2009 to 9.4 percent in 2010 through a combination of revenue enhancing (60 percent) and expenditure reducing (40 percent) measures. He believes the measures he is proposing are not overly ambitious and are achievable. He also acknowledged that budget cuts alone cannot solve all of Greece's problems; structural reforms are needed. To this end, he highlighted key reforms the GoG will introduce in the coming months, including pension reform, liberalization of closed professions, and removal of impediments to investment. The Ambassador stressed that these and other structural reforms were fundamental to restoring Greece's competitiveness, and that greater reliability and less bureaucracy were critical to improving Greece's investment climate. The Ambassador also raised bilateral issues, including Afghanistan and Pakistan assistance, debt owed to U.S. drug and medical suppliers, and the Thessaloniki Jewish Cemetery. END SUMMARY.

BROKEN TAX AND BUDGET ORGANS NEED REVAMPING

¶3. (SBU) Minister of Finance George Papakonstantinou admitted the state of Greek public finances was dire, suggesting broken tax administration and budget mechanisms lay at the root of the problem. He described the current taxation system as one that allows too many distortionary exemptions and lacks transparency and equitable burden-sharing between different professions - factors which promote the wide-spread tax evasion pervasive in Greece (estimated in the press to be on the order of 30 billion euro annually, or about 12 percent of GDP). He said that his predecessors have attempted to address both tax evasion and questions of fairness by balancing the level of taxation between, for example, employees (e.g., public servants) and the self-employed. In Papakonstantinou's view, merely adjusting the rate of taxation on direct earnings misses the crux of the issue, namely that lack of transparency and poor tax collection mechanisms allow people, particularly the self-employed, to underreport their earnings. [Note: Tax evasion is one of the most important contributing factors to Greece's large underground economy, according to the OECD which estimates it to be approximately 25 percent of GDP. End Note.]

¶4. (SBU) To overcome the huge problem of evasion, Papakonstantinou plans to develop a system that makes taxation more fair and equitable by forcing people to declare for the first time details of their finances and assets beyond just direct employment income, including real estate holdings, cars, bank accounts, and distributed earnings. The Ministry will then cross-check this information with tax filing forms in order to assess whether people are reporting their incomes accurately. Papakonstantinou also plans to introduce legislation that abolishes special exemptions for various classes of professionals, like athletes and architects. While such measures may be met with opposition from affected groups, he believes the measures are defensible because their aim is fairness. [Note: Papakonstantinou did not address how the GoG will stand up the systems and mechanisms necessary to monitor and cross-check all this information. Many press reports indicate that ratings agencies and other market watchers are skeptical of Greece's current tax administration and collection mechanisms, largely owing to a lack of qualified tax personnel and computerized and automated tax systems. End Note.]

¶5. (SBU) Echoing statements made publicly, the Minister emphasized that the 2010 budget currently in process is the last if its kind. As promised during the election, Papakonstantinou intends to launch a full review of the Greek budget process and is looking at how different countries like the United States structure their budget frameworks. He said that one problem with the Greek budget apparatus is that Greece's General Accounting Office (GAO), which is embedded within the Ministry of Finance, lacks independence. While the Greek GAO has responsibility for formulating the Greek budget and reporting on the costs and benefits of each piece of legislation, lack of independence limits its ability to accurately assess and report views contrary to GoG statements. The Greek budget process is further complicated by a lack of transparency and of checks and balances (e.g., the Congressional Budget Office) that would allow for a true public debate and differing perspectives to be taken into account. To underscore the importance of independence, transparency and checks and balances, the Minister noted the example of the previous government's privatization of Olympic Airlines. He claimed the new government has just discovered that the privatization has saddled Greece with a not-yet-quantified, but likely large, pension bill for years to come. Finally, the Minister agreed with the Ambassador that Greece could benefit from the adoption of a budget framework, similar to that which exists in the United States but adapted for Greece's Parliamentary system. Such a framework would include a budget resolution that would set annual targets and ceilings on the budget and appropriations process.

¶6. (SBU) Recognizing U.S. expertise in the areas of tax and budget policy and enforcement, Papakonstantinou asked Ambassador Speckhard for assistance in designing and implementing these reforms. He noted the IRS provided technical assistance to the Ministry in the late 1990s. The Ambassador expressed support, but recommended the Minister narrow down the specific areas in which he is interested. Papakonstantinou cited taxation of off-shore companies and establishing statistical models to help catch tax evaders as two key areas of need. In the budget arena, he welcomed the Ambassador's suggestion that meeting with experts at OMB, Treasury, CBO and the Congressional budget committees would be a good start to determining if the U.S. system could serve as a model. The Minister stated he would be willing to pay for such assistance, and the GoG would not care if news of such assistance became public.

BUT BUDGET AND TAXATION REFORM ARE NOT ENOUGH . . .

¶7. (SBU) Papakonstantinou compared Greece's economic problems with those of the United States, stating that both countries suffer from "twin deficits," or current account and budget deficits. He qualified, however, that unlike the United States, Greece unfortunately cannot print currency, and the euro is not the

world's reserve currency. Claiming he understands the EU is apprehensive that Greece's large budget deficit (projected to be 12.7 percent in 2009) and increasing public debt (currently over 115 percent of GDP) are creating systemic risks for the Eurozone, the Minister nonetheless expressed frustration with the level of criticism aimed at him by the EU and others over Greece's revised statistics. Papakonstantinou stated that his 2010 budget will reduce the deficit by 3.3 percent, or 7.8 billion euro, to 9.4 percent. Revenue-enhancing measures, including an extraordinary tax on the 2008 profits of banks and large businesses and collection of overdue taxes, account for 60 percent of the reduction, while expenditure cuts and nonrecurring items included in the GoG's revised 2009 deficit (e.g., hospital debt formerly not recorded on budget) account for the remainder. He argued that the measures he is proposing are not overly ambitious and are achievable. While the EU, ratings agencies and markets are pressuring for further cuts, the Minister claimed deeper cuts would be irresponsible without a more detailed understanding of contractual obligations ministries have made that impact the current budget and outyears. [Note: Approximately 80 percent of Greek outlays are considered non-discretionary or mandatory, with an estimated 40 percent alone going towards civil service salaries and pensions. In addition, ministries are known to enter into contractual obligations without concurrence from the Finance Ministry but which obligate the GoG to outyear financing. End Note.] He added that deeper cuts were not advisable in the face of Greece's first recession since 1993. More importantly, the Minister indicated, his hands were tied by election campaign promises, including a 2.5 billion euro stimulus package, from which the government could not walk away.

¶8. (SBU) Taxation and budget reforms and budget cuts alone cannot solve Greece's problems, according to Papakonstantinou. Greece needs major structural reforms, and Prime Minister Papandreou has already commenced or will soon commence public dialogue on many of these, including pension reform, deregulating closed or protected professions (e.g., notaries and truckers) , and removing impediments to domestic and foreign investment. He believes that the GoG must move quickly over the next 6 months, while the government's approval ratings are still high and its mandate fresh,

on these and other key structural reforms. The Minister hinted that a reduction of the public sector may also be in the offing. Noting he understood these were the purview of Minister of Economy, Competitiveness and Shipping Katseli, the Ambassador stressed that these and other structural reforms were fundamental to restoring Greece's competitiveness. He underscored that greater reliability in the tax structure, adequate judicial recourse for contract disputes, and less bureaucracy were critical to improving Greece's investment climate (see refTel A).

BILATERAL ISSUES

19. (SBU) The Ambassador thanked the Minister for Greece's support in Afghanistan and urged continued financial support, particularly on the assistance side in both Afghanistan and Pakistan. He also sought Papakonstantinou's assurances that the government would honor its debt to U.S. drug companies and medical suppliers. Papakonstantinou stated that his Ministry has acknowledged and included the debt owed to U.S. and European companies, estimated to be approximately 6.2 billion euros, in the 2009 budget and, together with the Ministry of Health, has established a process for coming to terms with and paying companies owed money. His goal is to complete this process in the next two months; however, he indicated, the GoG is banking on companies accepting a discount off of the total face value of debt they are owed, since the GoG would pay off the debt at one time. Finally, the Ambassador raised the Thessaloniki Jewish Cemetery restitution issue. He noted that the previous government had approved and tabled a 10 million euro settlement for the Jewish community in Thessaloniki as restitution for the cemetery destroyed by the Nazis in World War II and subsequently expropriated by the government. While the Minister was unaware of the status of this issue, he promised to look into it and bring it to a close.

COMMENT

10. (SBU) It is clear that the Minister has the expertise and a strong desire to tackle the problems that have led to a deterioration in Greece's public finances. Less clear, however, is whether the GoG has the capacity in the short- to medium-term to implement the reforms it envisages. While budget cuts are important, they are meaningless unless accompanied by an overhaul of Greece's taxation and budget frameworks. But such an overhaul will take time to build capacity currently lacking. According to the OECD, reducing tax evasion is one key to putting public finances on a strong footing. This, however, will be dependent upon the GoG's ability to implement computerized systems and hire personnel with the appropriate expertise. The other key to putting public finances on a strong footing is a budget framework under which the government can put an end to chronic spending overruns. Currently, the only entity in the GoG charged with budget responsibilities is the Ministry's GAO. In addition to lack of independence, it lacks the personnel and authority to properly "score" (or assess and assign costs) current and out-year costs of various pieces of legislation, as well as to monitor budget execution by the various line Ministries. While the GoG is in the process of adopting a program-based, multi-year budget process that will help enforce discipline by spelling out the cost and outcome of each activity itemized in the budget, it is slow going, and the government currently has no way to ensure ministries limit spending according to their annual budgets. Greek ministries often spend their entire discretionary and non-discretionary annual allotments by the second or third quarter, forcing the GAO to give them additional funding to meet payroll for the remaining year.

According to the OECD, this system is a key contributor to Greece's chronic expenditure overruns, which in turn are driving Greece's budget deficit (see reftel B).

¶11. (SBU) COMMENT CONTINUED. The linchpin to both near-term budget cuts and a longer-term tax and budget overhaul is maintaining the political will to undertake these reforms in the face of weakening public support, as well as dissension within PASOK itself, where some have labeled it as a battle between the party and the government. Despite a comfortable parliamentary majority (160 of 300 seats) PASOK's political will has already shown signs of wavering before vested interests in the government bureaucracy, trade unions, and the left wing of the party. In the span of 48 hours last week, the government announced a public sector salary freeze and then quickly scaled this back in the face of criticism from public servant unions and the party base, agreeing instead to apply the freeze to only those public employees who earn more than 2,000 euros per month (a mere 40,000 out of 560,000 civil servants). Such irresoluteness merely will serve to strengthen the hand and will of other special interest groups as the GoG announces measures that impact them. The government has not even begun to break china on the much tougher issues like pensions and taxing the full standard of living of the self-employed (who are reported to be the biggest class of tax evaders and make up only 4 percent of the Greek tax base). END COMMENT.
Speckhard